FitchRatings

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Fitch Affirms Aareal Bank at 'BBB+'; Negative Outlook

Fitch Ratings - Frankfurt am Main - 24 Nov 2020: Fitch Ratings has affirmed Aareal Bank AG's (Aareal) Long-Term Issuer Default Rating (IDR) at 'BBB+' and Viability Rating (VR) at 'bbb+' and removed them from Rating Watch Negative (RWN). The Outlook on the Long-Term IDR is Negative. A full list of rating actions is below.

The affirmation of Aareal's Long-Term IDR and VR and removal from RWN reflects our view that the economic fallout from the coronavirus crisis represents a medium-term risk to Aareal's ratings, rather than a near-term risk, which was our base case when we placed the ratings on RWN in April 2020. Aareal's relative resilience in 9M20 suggests that the bank should be able to retain a financial profile commensurate with its VR through the crisis, even though its earnings and asset quality are likely to face some near-term pressure.

The Negative Outlook on Aareal's Long-Term IDR reflects downside risks to our expectations of Aareal's relative resilience as a materially slower than expected economic recovery could have a greater weight on its earnings and asset quality than our base case suggests.

Key Rating Drivers

IDRs, VR AND SENIOR NON-PREFFERRED UNSECURED (SNP) DEBT RATING

Aareal's VR reflects the bank's focus on the cyclical commercial real estate (CRE) sector as part of its established business model, as well as its exposure to the associated risks of this market. The bank remains in particular exposed to COVID-19 related effects in its hotel and retail segments. At the same time, the bank's stable recent performance, geographical diversification, diversified funding mix and sound capitalisation support the VR.

Due to de-risking measures, Aareal's reported nonperforming loan (NPL) ratio (which includes off-balance sheet, fair value NPLs and IFRS Stage 3 loans in the numerator) decreased to 3.9% at end-3Q20 from 4.2% at end-2019 and from the recent peak of 7.3% at end-2Q19. The reduction was achieved mainly through the sale and repayment of NPLs. However, we expect NPL inflows to increase in 2021 when state support measures recede and the effect of the crisis on asset quality becomes more apparent.

Aareal has elevated exposure to hotels (33% of total real estate loans at end-3Q20) and retail property (23% at end-3Q20), partially in more volatile regions. Both segments have been the most affected by the pandemic so far. If business travel does not return to close to pre-pandemic levels in the short term, these segments are likely to remain under pressure for longer.

The bank's profitability was under pressure in 9M20, reporting a significantly lower operating profit/ risk-weighted assets (RWA) relative to 2019, as loan impairment charges (LICs) more than doubled. A large part of Aareal's LICs was related to management overlays, rather than actual defaults, in light of the expected deterioration in asset quality. The bank's revenues have been broadly stable, with only a slight decrease in net interest income, Aareal's main revenue source, due to lower new business volumes due to the COVID-19 pandemic. In contrast, margins have held up well so far. We expect the bank's profitability to recover in 2021 as business volumes recover, as we do not expect the same severe lockdown restrictions as in 2020.

We expect the bank's pre-impairment profit generation to remain a sufficient first line of defence through the crisis. Our base case assumes that Aareal will maintain a four-year average operating profit/ RWA of at least 1.5% through the crisis, in line with its earnings and profitability score of 'bbb+'.

Aareal's capitalisation remains a rating strength in our view, given its sound common equity Tier 1 (CET1) ratio of 20.4% at end-3Q20, well above the SREP CET1 requirement of 8.28% in 2020 (with Pillar 2 requirements relief). The partial sale (30%) of its IT subsidiary Aareon closed in November 2020 and will contribute about EUR180 million (after tax) to the bank's consolidated equity, adding about 150bp to the bank's CET1 ratio on a pro-forma basis. The bank is also not constrained by its regulatory leverage ratio, which at 6% at end-3Q20 compares well with other specialised CRE lenders. In our view, the bank is well positioned to absorb the impact of regulatory changes on its RWA, such as the finalisation of the Basel III framework, including the output floor, and the effects from prudential provisioning guidelines for non-performing exposures, given its pro-forma CET1 ratio of 14.2%.

Aareal's funding is diversified and consists primarily of deposits from the institutional housing sector and Pfandbriefe. The bank's reliance on unsecured market funding is reduced by its deposit funding, which has been a reliable and stable source of funding for the bank. The bank's unsecured funding is predominantly derived from private placements from an established investor base.

The bank's Short-Term IDR of 'F2' corresponds to the lower of the two options mapping to a 'BBB+' Long-Term IDR and reflects Fitch's assessment of Aareal's funding and liquidity.

DERIVATIVE COUNTERPARTY RATING (DCR), DEPOSIT AND SENIOR PREFERRED DEBT RATINGS

Aareal's DCR, long-term deposit rating and long-term senior preferred debt rating are rated one notch above the Long-Term IDR due to the bank's large buffer of senior non-preferred debt of 43% of RWAs at end-2Q20. In our view, this buffer provides the bank's preferred creditors and counterparties with considerable additional protection compared with senior non-preferred creditors in resolution. The bank's short-term deposit rating and short-term senior preferred debt rating at 'F2' is the baseline option corresponding to the long-term deposit rating and long-term senior preferred debt rating of 'A-'.

Two rated notes (DE000A12T762, DE000A12T705) contain embedded derivatives and therefore rank as senior preferred debt under the German resolution regime.

SUPPORT RATING (SR) AND SUPPORT RATING FLOOR (SRF)

Aareal's SR and SRF reflect Fitch's view that due to the EU's Bank Recovery and Resolution Directive (BRRD), under which senior creditors can no longer rely on full extraordinary support from the sovereign if the bank becomes non-viable.

TIER 2 SUBORDINATED DEBT AND HYBRID SECURITIES

Aareal's Tier 2 notes are notched down twice from the VR at 'BBB-', to reflect higher loss severity of this type of debt relative to senior debt. The Basel III-compliant additional Tier 1 (AT1 notes) are rated four notches below the VR. These notes are notched down twice for loss severity, due to their deep subordination and write-down on breach of the 7% CET1 trigger, and twice for incremental non-performance risk relative to the VR to reflect fully discretionary coupon payments.

RATING SENSITIVITIES

The Long-Term IDR and SNP debt ratings are sensitive to changes in Aareal's VR. The DCR, deposit ratings and senior preferred debt ratings are primarily sensitive to changes in the bank's IDRs. The ratings of the Tier 2 and AT1 notes are primarily sensitive to changes in the VR as well as changes in their notching.

Factors that could, individually or collectively, lead to positive rating action/ upgrade:

The Outlook on the Long-Term IDR could be revised to Stable if the bank's operating environment stabilises and the bank successfully manages the challenges arising from the crisis, limiting downside risks to its asset quality and profitability, while maintaining current capital levels.

An upgrade of Aareal's VR is unlikely in the near term, given the risks posed by the coronavirus shock. An upgrade of the VR would require significant progress in the diversification of the bank's business model into revenue sources that are not directly correlated or rely on the bank's dominant large-ticket CRE lending.

An upgrade of Aareal's IDRs would trigger an upgrade of the DCR, SP debt and deposit ratings, unless the buffer of junior and SNP debt decreases below the level required to maintain the one-notch uplift above the bank's Long-Term IDR. This could be the case if the bank decides to use SP debt to meet its resolution buffer requirement, and if this reduces the buffer of junior and SNP debt below 10% of its RWAs.

An upgrade of Aareal's SR and upward revision of the bank's SRF would require a higher propensity of sovereign support. The BRRD makes this highly unlikely, albeit not impossible.

An upgrade of Aareal's VR would lead to an upgrade of the Tier 2 and AT1 notes.

Factors that could individually or collectively, lead to negative rating action/ downgrade:

A quicker than expected or a more significant deterioration in the bank's NPL ratio, for example if we expect it to exceed 6% without a clear path of reducing it below this level, would trigger a downgrade of the bank's VR. Furthermore, if earnings weaken through asset quality pressure or stresses in the property market related to COVID-19, to the extent that it would ultimately weaken Aareal's substantial capital buffers, we would also likely downgrade the bank.

A downgrade of Aareal's IDRs would trigger a downgrade of the DCR, SP debt and deposit ratings. We could also downgrade these ratings if we expect the buffer of junior and SNP debt to decrease, in particular if the bank decides to use SP debt to meet its resolution buffer requirements, unless the buffer of junior and SNP debt is likely to remain sustainably above 10% of its RWAs.

Aareal's SR and SRF are at the lowest levels on Fitch's rating scales and therefore cannot be downgraded.

A downgrade of Aareal's VR would lead to a downgrade of the Tier 2 and AT1 notes. The ratings of the AT1 notes could also be downgraded if we see a heightened risk of capital cushions above maximum distributable amount trigger points falling below 100bp.

Best/Worst Case Rating Scenario

International scale credit ratings of Financial Institutions and Covered Bond issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of four notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit [https://www.fitchratings.com/site/re/10111579]

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG Considerations

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of '3'. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg

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Rating Actions

ENTITY/DEBT	RATING			RECOVERY	PRIOR
Aareal Bank AG	LT IDR	BBB+	Affirmed		BBB+
	ST IDR	F2	Affirmed		F2
	Viability	bbb+	Affirmed		bbb+
	Support	5	Affirmed		5
	Support Floor	NF	Affirmed		NF
	DCR	A-(dcr)	Affirmed		A-(dcr)

ENTITY/DEBT	RATING			RECOVERY	PRIOR
• subordinated	LT	BBB-	Affirmed		BBB- ⬙
• subordinated	LT	BB	Affirmed		BB ⬙
• long-term deposits	LT	A-	Affirmed		A- ⬙
• Senior preferred	LT	A-	Affirmed		A- ⬙
• Senior non-preferred	LT	BBB+	Affirmed		BBB+ ⬙
• short-term deposits	ST	F2	Affirmed		F2
• Senior preferred	ST	F2	Affirmed		F2

RATINGS KEY	OUTLOOK	WATCH
POSITIVE	⊕	⬘
NEGATIVE	⊖	⬙
EVOLVING		◆
STABLE		

Applicable Criteria

Bank Rating Criteria (pub.28 Feb 2020) (including rating assumption sensitivity)

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